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## **Some Thoughts on GE**

In the past year, GE's stock has fallen from a high of \$42.15 to a recent low of \$5.73 before rebounding to its present level near \$11. The collapse of GE is primarily due to deterioration in the loan and commercial real estate portfolios in GE Capital that before the collapse represented about 60% of GE's profits. Secondly, the world economic slowdown has worsened the prospect for the industrial sector of GE.

Fears that the capital losses associated with GE capital would leave it insolvent were behind the extreme nature of the price collapse. Those fears prompted GE CFO Keith Sherin to conduct what he referred to as a "deep dive" analysis of GE's capital market portfolio. The 5-hour presentation took place on Thursday, March 19. It was designed to give more transparency into GE's financial business, to allay investor fears as to the prospect that GE's stock price was vulnerable to a complete collapse, to shore up its bond prices, and to prevent a further downgrade (S&P and Moody's already downgraded the stock a notch). In particular, GE applied a stress test to indicate that, even under their worst assumptions for the economy and financial system, GE capital earnings would not go meaningfully negative, and that it would have adequate capital to ensure maintaining their rating.

The webcast of the March 19 presentation and other financial communications can be found on the GE website. The purpose of this report is to update my assessment of GE and its stock price, given recent developments.

First, GE is not likely to go out of business or suffer the same fate as, say GM and C (which, at the very least, have greatly diluted stock). Having said that, I have considerable concern about the near and intermediate prospects for GE and its stock price. Regarding its price, my conclusions are:

- ◆ GE remains vulnerable to a "weak" test of its recent low. My 3 to 4-month range is \$7-9 on the downside and \$11-14 on the upside. We are currently at \$11.
- ◆ A continuing earnings cloud will limit the 1-year range. Upside is likely limited to the \$15-18 area and during much of that 1-year period the price is likely to remain in the \$8-15 range.
- ◆ Longer term, 3-5 years, GE's price is unlikely to approach the October 2007 high. A reasonable objective over that period is \$22-30.

### ***Concerns:***

My concerns are as follows:

- ◆ Like the Administration (see my earlier piece on the economy and stimulation) GE management still appears to have too much optimism in their forecast and stress test. Their base case is for a peak unemployment rate of 8.5% (we are already there) and a GDP loss this year of 1.8%. Their “worst case” is for an unemployment rate of 10.3% and a GDP loss of 3.3%. My base case is closer to Federal Reserve’s base case, i.e. a peak unemployment rate of 9.3% and a GDP drop near 3%. Most analysts agree and have built in earnings to reflect a more pessimistic base case.
- ◆ GE is in the “early innings” of its loan losses and asset revaluations. Unlike the big banks that have already experienced the worst of their loan losses (from residential housing), GE’s loan losses for private label credit cards, lending to Eastern European banks, U.K mortgage lending, and commercial real estate loans and holdings, will increase this year beyond GE’s base case. Based on Sherin’s own estimate, GE will suffer loan losses of at least \$30-35 billion which will be written off over a three-year period. In my opinion, a “worst case” scenario would result in loan losses approaching \$60 billion. While GE has enough capital to withstand such losses (which is why I think they will survive), that would represent close to a \$6 a share hit (GE has approximately 10.5 billion shares outstanding) to earnings spread out over 3 years. In my earnings estimates below, I have used Sherin’s estimate.
- ◆ Although GE’s industrial (non-financial) business will continue to generate good earnings (it should benefit from a number of Administration initiatives), the “late cycle” nature of much of its business (it is concentrated in capital equipment) will slow future growth, as new orders will be slow to develop and backlogs are worked down.

### ***Earnings:***

GE has set aside much less loan-loss reserves than banks that have been forced to write down residential mortgages. It also marks very little to market and thus its capital structure will not benefit much from the recent relaxation of FASB rules. However, by spreading out its losses over the next three (or more) years, GE will be constraining its earnings in future years. While I was with Merrill Lynch, the firm usually wrote off as much as possible and set aside copious reserves in the down years. Thus, they were able to show much bigger earnings gains in the “out” years as the loan-loss set asides and write offs disappeared. By contrast, distributing write-offs over several years will hold down GE’s future earnings.

GE earnings in 2006, 2007 and 2008 were \$1.99, \$2.20, and \$1.72 respectively. A month before the March 19 presentation, the consensus for 2009 earnings was in the \$1.20-1.30 range, with a gradual increase expected thereafter. Following the presentation the consensus estimate has been lowered to \$1.00, with a couple analysts looking for 2009

earnings in the \$0.70-cent range. The rebound in GE's price since then suggests that, on the margin, investors were way ahead of the analysts in their assessment.

I do not prepare my own earnings analysis, but my view on earnings is as follows: In order to maintain some semblance of a growth profile and given that recent data is worse than the GE's recent base case, it makes sense to be a bit aggressive in current write-offs to allow for a gradual decrease in future write-offs in the out years. Thus, I think earnings in 2009 are likely to come in lower than the consensus, say in the \$0.60-0.80 range. However, to preserve capital in the near term, I suspect it is the latter 2009 quarters that will deviate most from the current consensus. Peak earnings on the industrial side of GE were about \$1.00 and I am assuming these will fall this year to the \$0.60-0.80 area. I am also assuming that, despite GE's management contention that earnings will be positive this year even under the stress-test case, the result will ultimately be at the lower end of GE's worst case estimate of negligible earnings.

Given the announced intention to spread loan losses and write-offs over several years, my out-year earnings estimates are for earnings to return to, say, the \$1.00-1.10 level in 2010 (close to the current consensus), and then gradually increase by, say, 10-15% thereafter. This would put earnings in the \$1.40-1.80 area five years hence (vs. the \$2.20 earnings peak in 2007). Thus my optimistic forecast suggests a return to about the 2008 earnings level. If one applies what I think is a reasonable PE ratio of, say, 16-18, consistent with a moderate and sustained economic recovery, a five-year price objective would be between \$22-30 a share.

### ***Strategy:***

While the current rebound in the stock price may carry a bit further as first quarter earnings are better than the "worst case", I am a seller in the \$11-12 range based on the expectation that I will get another opportunity to buy in the \$8-10 area. For those using options, I think the best near-term trading strategy is to write covered calls (May or June) at the \$12 level. An aggressive speculative strategy, if the stock price returns to, say, the \$8 level, is to write the intermediate-term puts which should, at that point, offer a quite high annualized rate of return.

If one takes a longer-term investment view, I would write longer-dated calls (September or January), with \$15-18 strikes.

### ***Assumptions:***

- ◆ I am assuming that, having cut its dividend rather deeply from \$1.24 to \$0.40 annually, GE will be able to maintain that rate over the next 2 years and may increase the dividend rate slowly thereafter. The dividend is one factor that should support a price base for GE that is higher than the "extreme" March 4 low under \$6.00.
- ◆ Regarding the economy, I am assuming that GDP will contract approximately 3% this year, grow 2% in 2010 and have a growth central tendency of 2-3%

thereafter. Nominal growth and inflation will likely remain fairly subdued through the middle of 2010, but beyond that point I feel quite uncertain.

- ◆ Regarding the general stock market, I am assuming the current S&P rally will not carry beyond the 870-920 range and will, at some point, trade back to the 700-750 range as investors and analysts scale back their current optimistic interpretation of forthcoming data (investors seem willing to overlook the horrible employment data because of its “lagging” nature).

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